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March 13, 2006

AGENDA ITEM 7a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** AIM Strategic Review Implementation Update
- II. PROGRAM:** Alternative Investment Management (AIM) Program
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

At the October 2005 Investment Committee meeting, the Investment Committee adopted the strategic review of the AIM Program conducted by Pension Consulting Alliance (PCA). In December 2005, the Investment Committee approved the action plan (Attachment 1) for the strategic review and directed AIM Staff to provide a quarterly status update. This agenda item represents the first update. PCA is providing consulting services in connection with the implementation of the action plan.

The key findings of the strategic review were to:

- 1) Reduce the number of relationships managed by AIM Staff
- 2) Utilize new vehicles managed by 3rd parties to make smaller investments
- 3) Transition the organizational structure
- 4) Enhance delegated authority
- 5) Explore co-investment strategies
- 6) Evaluate and enhance use of external resources
- 7) Evaluate AIM benchmarks

The following represents an update with respect to these key elements:

- **Reducing relationships** – The strategic review recommended reducing the number of relationships managed by AIM Staff. Staff has identified those relationships that are core, prospective core, and legacy. As reflected in the action plan, Staff will have direct oversight of core and prospective core relationships. Staff and PCA are evaluating options with respect to management of legacy relationships. One option that appears attractive is to place the legacy partnership interests into a separate account which would be managed by a third party. The third party would have direct oversight of the legacy partnerships and would seek to maximize the value of the portfolio through a variety of active management strategies. Some portion of the legacy relationships will have the potential to grow and receive capital from CalPERS in the future, while others will be wound-down or potentially sold. Other options that are being explored include secondary market transactions as well as other 3rd party transactions. Staff and PCA will continue to evaluate options, managers, and other transactions with respect to the legacy portfolio. Staff and PCA expect the manager or transaction selection process to be complete during the third quarter of 2006.
- **Utilizing new vehicles for smaller investments** – The strategic review recommended leveraging 3rd parties for smaller investments. While the definition of “smaller” has not yet been determined, Staff and PCA have worked collaboratively to develop the concepts for a variety of new vehicles. New vehicles are defined as an investment in a fund where CalPERS partners with a firm(s) that has a distinctive competitive advantage in an industry, geographic region or investment style and where CalPERS is the sole limited partner or large anchor investor. New vehicles are commonly structured as fund-of-funds or separate accounts. Staff and PCA have developed initial concepts for the new vehicles/fund-of-funds shown below:
 - Domestic Emerging Managers
 - International Emerging Markets
 - California Investments
 - Clean Energy & Technology
 - Middle Market Private Equity
 - Venture Capital

Staff and PCA will evaluate 3rd party investment managers (General Partners) for each of the new vehicles above. The scope, strategy, and structure of these vehicles will be further developed and refined through the evaluation process. While the manager evaluation/diligence/selection process will run concurrently for each of the vehicles above, it is expected that the vehicle creation process (i.e., full due diligence, legal structuring, etc.) will be

completed in groups of two or three, with the final group completed no later than the fourth quarter of 2006.

- **Transitioning the organizational structure** – The strategic review recommended transitioning to a more vertical organizational structure and realigning roles and responsibilities of staff. The organizational structure proposed in the action plan has formally been put in place, and roles and responsibilities are currently being realigned. The AIM Unit is in the process of recruiting two portfolio managers and two investment officers. In addition, AIM has requested approval for an additional portfolio manager through the FY 2006/2007 formal budget request process. Filling these positions is a high priority for the AIM Unit, and Staff will keep the Investment Committee apprised of status in this effort.
- **Enhancing delegated authority** – Changes to delegated authority require separate approval from the Investment Committee. Staff has worked with the Legal Office to draft proposed changes to the delegation resolution consistent with the strategic review and action plan. The changes, which would be presented to the Investment Committee for approval at a later date, would result in greater staff discretion for new vehicles and co-investments and would amend certain definitions to comport with the intent of the policy. Staff is prepared to bring these proposed changes forward to the April 2006 Investment Committee meeting.
- **Exploring co-investment strategies** – As reflected in the action plan, implementation of this finding is a lower priority from a timing standpoint. Staff expects to begin evaluating options with respect to co-investing in the third quarter of 2006.
- **Evaluating use of consultants** – The AIM Unit will be working with PCA to develop a new evaluation process for its external resources (e.g., consultants). The new evaluation process would be conducted annually beginning at fiscal year end 2005/2006. In addition, AIM is in the final stages of the RFP process for refreshing its spring fed pool of external resources. Staff plans to provide an update regarding consultants selected at the April 2006 Investment Committee meeting.
- **Evaluating AIM benchmarks** – Frank Russell & Co. has evaluated AIM's benchmarks and has provided Staff with a recommendation. The recommendation is being reviewed by Staff and PCA. Staff expects to bring recommendations regarding changes to the AIM benchmark to the April 2006 Policy Sub-Committee meeting.

Implementation of the strategic review remains the highest priority of the AIM Unit. The timing noted in this agenda item is Staff's and PCA's best estimate. Staff and PCA endeavor to complete tasks ahead of plan.

V. STRATEGIC PLAN:

Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX, achieve long-term, sustainable, risk-adjusted returns.

VI. RESULTS/COSTS:

None. This agenda item is for information purposes only.

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